United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

Docket No. 75-4138

IN THE

United States Court of Appeals

For the Second Circuit

GERALD F. PADUANO and CAROLINE PADUANO,

ROCCO M. CAPPUCCILLI and DOROTHY CAPPUCCILLI,

PETER L. CAPPUCCILLI and GRACE A. CAPPUCCILLI,

Petitioners-Appellants,

—*vs.*—

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

On Appeal from the United States Tax Court

BRIEF FOR PETITIONERS-APPELLANTS

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-vs-

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On Appeal from the United States District Court
for the Northern District of New York

APPELLANTS' BRIEF

STATEMENT OF ISSUES PRESENTED

1. Whether interest income should be imputed under section 482 of the Internal Revenue Code of 1954, as amended,[1] to sales of real estate on a time basis, where said real estate was held by seller for speculation and investment purposes and not for sale to customers in the ordinary course of business.

2. Whether interest income should be imputed under section 482 of the Internal Revenue Code of 1954, as amended, to sales of real estate on a time basis if the selling price exceeded the fair market value of the real estate at the time of sale and the difference included interest?

3. Whether interest income should be imputed under section 482 of the Internal Revenue Code of 1954, as amended, to situations where the obligor has no funds with which to pay interest on obligations which the obligor owes to a taxpayer related to or controlling the obligor?

STATEMENT OF THE CASE

A. Proceedings Below

This is an action brought by petitioners Gerald F. Paduano and Caroline Paduano, Rocco M. Cappuccilli and

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[1] All section references are to the Internal Revenue Code of 1954, as amended.

Dorothy Cappuccilli, and Peter L. Cappuccilli and Grace A. Cappuccilli, to contest the determination of the Commissioner of Internal Revenue, respondent, who imputed interest income to petitioners under section 482 because interest was not paid on loans and mortgages which related entities owed to petitioners' partnership.[2] The case was tried in the United States Tax Court before Judge William M. Fay, in New York City, on October 1, 1973, who upheld the income tax deficiencies asserted by the respondent, (T.C. Memo 1975-69).[3] Petitioners appeal that decision.

B. Statement of Facts[4]

Gerald F. and Caroline Paduano, Rocco M. and Dorothy Cappuccilli, and Peter L. and Grace A. Cappuccilli, husbands and wives, filed joint Federal income tax returns for the years in issue (1967, 1968 and 1969) with the District Director of Internal Revenue, Buffalo, New York, and were residents of Syracuse, New York, when the Petitions herein were filed. (60a, 61a; J. Ex. 1-A - 9-I)

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[2] The partnership consisted only of the husbands and hereafter petitioners shall refer to Gerald F. Paduano, Rocco M. Cappuccilli and Peter L. Cappuccilli or to their partnership, Cappuccilli, Cappuccilli, and Paduano (CCP).

[3] CCH Tax Ct. Rep. Dec. 33097 (M)

[4] Reference to appendix is indicated by page number followed by small letter 'a' and to exhibit volume by page number followed by small letter 'e'.

In 1954 Gerald Paduano, Rocco Cappuccilli and Peter Cappuccilli (petitioners) formed the partnership of "Cappuccilli, Cappuccilli and Paduano" (CCP) in which each had a one-third interest and which engaged principally in the business of renting and selling realty. Each of petitioners also held a one-third interest in Stonehedge Development Corporation (Stonehedge) organized on April 8, 1953; Seneca Sewerage Corporation (Seneca) organized on April 1, 1961; and Cappy's Real Estate, Inc. (Cappy) organized on September 3, 1958. (62a)

SENECA KNOLLS - SALE BY CCP TO STONEHEDGE

As a result of exercising options, during the period February 22, 1961 - January 3, 1962, CCP acquired for investment and speculation and not for sale to customers in the ordinary course of its trade or business, the following contiguous farms known collectively as Seneca Knolls at a total cost of $320,083.

FARM	OPTION DATE	PURCHASE DATE	PURCHASE PRICE
Walter	2- 7-58	2-22-61	$ 64,065
Commane	11-19-58	10-20-61	$ 71,830
Green	3-15-60	10-26-61	$ 34,788
Patterson	9- 1-60	11-24-61	$ 22,400
Higgins	10-13-58	1- 3-62	$127,000

(64a; J. Ex. 33-AG - 39-AM)

Stonehedge, for development purposes, acquired Seneca Knolls from CCP on January 10, 1962 in consideration

of $1,353,600 to be paid as follows: a cash payment of $3,430; assumption of mortgage obligations of $275,170; and a note of $1,075,000, bearing no interest, secured by a purchase money mortgage and providing for payments of $75,000 on January 10, 1964, and of $100,000 on January 10th of each of the ten succeeding years. A gain of $1,033,517 resulted from the sale. (64a; J. Ex. 33-AG - 39-AM)

The fair market value of Seneca Knolls at time of sale (selling price $1,353,600) to Stonehedge was $720,000 and CCP would have taken a cash price of that amount. Based on the fair market value, CCP's equity in Seneca Knolls was approximately $400,000. (99a, 101a)

According to the testimony of petitioner, Peter Capruccilli, the difference between the selling price (of $1,353,600) and fair market value (of $720,000) was intended to be interest of $636,600. (101a, 102a)

HENDERSON - SALE BY CCP TO STONEHEDGE

On December 7, 1959 CCP took an option on Henderson Farm and exercised said option on March 8, 1960; the purchase price was $125,460. This farm was adjacent to Seneca Knolls property and was purchased by CCP for investment and speculation. (114a; J. Ex. 39-AM; Ex. 44) Stonehedge acquired the property from CCP for development

purposes on February 20, 1961 in consideration of $216,500 to be paid as follows: a cash payment of $27,894.86; the assumption of mortgage obligations of $107,604.15; and a note of $81,000 bearing interest at six per cent, secured by a purchase money mortgage and providing for payments of equal amounts on the first and second anniversaries of the sale. (J. Ex. 33-AG; 34-AH; 35-AI; 39-AM) A gain of $91,100 resulted from the sale of the Henderson farm, but its fair market value was only $175,000 at that time. The difference in sales price ($216,500) and fair market value was $41,500. This difference was intended to represent interest of at least seven per cent, based on testimony of Peter Cappuccilli. CCP's equity in Henderson was approximately $29,000 after the payment of $11,000 in 1962. (115a, 116a, 117a; J. Ex. 33-AG)

REPAYMENT PLAN AND FORECLOSURE - SENECA KNOLLS AND HENDERSON

The mortgage obligations (from Seneca Knolls and Henderson sales) due CCP from Stonehedge were to be paid from lots developed and sold by Stonehedge (approximately 1100 lots) over a 10-12 year period, or about 100 lots per year, based on past performance. (103a)

Shortly after acquiring the properties from CCP and prior to development, Stonehedge encountered many

difficulties which ultimately caused the company to cease its land development business. In 1962 the Town of Van Buren (Onondaga County, New York) set up higher zoning standards with respect to lot development, which resulted in higher costs to a developer. Various appeals by Stonehedge on the new zoning requirements took several years and a settlement was not reached until 1965. (104a, 105a) Another factor, was the slump in the building industry during the mid-1960's.

Also, in 1962, New York State indicated that a highway would be constructed which would affect the Seneca Knolls property. From 1962 to 1968 the exact location was unknown. The actual taking (about fifty acres) took place in 1968 but the highway was not completed until 1971. (105a, 120a, 121a, Ex. 44)

Because of these obstacles, Stonehedge was unable to develop lots as planned, and as a result there was no cash flow with which to pay off the mortgage obligations (including interest) due CCP on Henderson and Seneca Knolls properties as originally agreed. (122a)

Although interest was paid (from funds advanced by CCP to Stonehedge) on mortgages due third parties on these properties no principal payments were made during

1967, 1968 and 1969. But no foreclosure action was taken by any third party against Stonehedge. (106a, 122a, 123a)

Of the original $1,075,000 due CCP on Seneca Knolls property, $22,150 was paid prior to 1967 leaving a balance of $1,052,850. (64a)

Of the $81,000 due on Henderson, $11,000 was paid in 1962. As of March 14, 1972 a total balance of $1,122,850 ($1,052,850 plus $70,000) was due to CCP by Stonehedge. This sum was paid as follows: $223,756 cash on March 14, 1972 and the balance of $899,094 as the result of a voluntary foreclosure agreed to by CCP and Stonehedge on the remainder (after New York State appropriation) of the Seneca Knolls property and Henderson Farm. (64a, 107a, Ex. 45, 46, 47)

On the foreclosure which was in full satisfaction of the total amount of $899,094 due to CCP by Stonehedge; CCP received about three hundred acres of land worth $3,000 per acre. (108a, 110a, Ex. 45) Gerald Paduano, partner in CCP sold his one-third interest in the foreclosed property (300 acres) to the other two partners for $299,698 (one-third of $899,094) on March 14, 1972. (11a, 114a, Ex. 48, 49) According to expert testimony interest of at least five per cent was earned on CCP's equity in Seneca Knolls and Henderson from date of sale to dates of payment and foreclosure. (117a, 139a - 141a)

PRESTON - SALE BY CCP TO SENECA, AND PAYMENT

CCP purchased the Preston Farm from Stonehedge on April 15, 1961 for $22,500. One half of this land was sold on April 16, 1961 to Seneca Sewerage for $40,000 for a sewerage disposal plant to serve the entire area that was assembled, (Seneca Knolls and Henderson Farm); the sale terms were: $5,000 cash; $10,000 assumption of mortgage; and $25,000 note secured by a purchase money mortgage at six per cent interest and was to be paid in full on April 16, 1966. CCP realized a gain of $28,750 on the sale to Seneca. (J. Ex. 40-AN; 42-AP; 43-AQ; 65a; 118a)

The fair market value of the one-half Preston farm on April 16, 1961 was $21,250, and if sold by CCP on a cash basis that would have been the amount taken by CCP. (119a) The difference in the selling price of $40,000 was intended to be interest of at least seven per cent according to the testimony of Peter Cappuccilli. (119a) Based on fair market value CCP's equity in that sale was $6,250. (119a, J. Ex. 40-AN, 42-AP, 43-AQ), and interest of more than five per cent was earned by CCP on its equity from the date of sale to date of payment, according to expert testimony. (141a)

ADVANCES BY CCP TO STONEHEDGE, SENECA AND CAPPY

Because Stonehedge encountered many problems, (explained above) which impeded development, it lacked cash resources. Banks were unwilling to loan to Stonehedge. As a result CCP was required to make advances so that Stonehedge could meet its payments on third party obligations, including mortgages. Also, non-interest loans were made by CCP to Seneca and Cappy in order to keep these entities in existence (they also could not borrow from banks).

OTHER MATTERS

Although Peter Cappuccilli testified that interest was intended to be included in the sales of Seneca Knolls, Henderson and Preston, a protest filed with the Appellate Division of the Internal Revenue Service on behalf of petitioners stated in essence that there was no agreement oral or otherwise for charging interest on the obligations to CCP incurred by the related entities. (Ex. AR, AS, AT)

In the CCP partnership returns filed for 1961 and 1962, the public accountant for CCP classified the sales of real estate by CCP to Stonehedge and Seneca as "net gain (or loss) from sale or exchange of property other than

capital assets." However, as mentioned above, Peter Cappuccilli testified that said properties were held for investment and speculation. (J. Ex. 10-J, 11-K

Petitioners and respondent stipulated that if interest is to be imputed, a rate of five per cent would be applied. (65a)

SUMMARY OF ARGUMENT

It is submitted that there are three reasons why the decision of the United States Tax Court was erroneous:

First: Section 482 does not apply to sales of real estate which were held for investment purposes.

Second: Section 482 should not apply to situations in which interest was included in the selling price.

Third: Section 482 should not apply where the obligor has no funds with which to pay interest on obligations it owes to a related or controlling taxpayer.

Under the regulations interest shall be imputed on all forms of indebtedness including "indebtedness arising out of the ordinary course of business out of sales . . . by or between members of the group . . ." (Reg. Sec. 1.482-2(a)(3)(ii)) It will be noted that there is no reference to sales of capital assets under section 482 or the regulations. The facts support petitioner's contention that the subject properties: Seneca Knolls, Henderson Farm and Preston Farm were purchased by CCP for investment and speculation and not for sales to customers in the ordinary course of its business. Peter Cappuccilli testified that CCP did nothing to the properties other

than to negotiate for their purchase and to assemble a total package which would enhance the value of all properties. (114a, 118a) There is nothing in the record to show that property was offered for sale, or was advertised, or was placed in a broker's hands for sale, or improved in any way prior to sale, and it was not listed as inventory on its partnership return. Also significant is the fact that only three sales of farm property were made during 1961 and 1962; i.e.

On 2-20-61, sale of Henderson to Stonehedge

On 4-16-61, sale of Preston farm to Seneca

On 1-10-62, sale by CCP of Seneca Knolls

All of these factors are important in determining whether real estate is held for sale in the ordinary course of business. (Gault v. Commissioner, 332 F2d 94 (2d Cir. 1964); Estate of Segal v. Commissioner, 370 F2d 107 (2d Cir. 1966) Therefore, because the properties in question were held for investment and speculation and not for sale to customers in the ordinary course of CCP's trade or business, the obligations owed thereon do not come within the purview of section 482.

In the three sales involved from CCP to Stonehedge and Seneca, there was undisputed testimony that in

each case the selling price far exceeded the fair market value at the time of the sale and that the difference was intended to be interest. Seneca Knolls' selling price $1,353,600 and fair market value at date of sale $720,000; Henderson Farm's selling price $216,500 and fair market value at date of sale $175,000 and Preston Farm's selling price $40,000 and fair market value at date of sale $21,250. An expert testified that from the date of the sale to the date of final payment, including foreclosure by CCP, interest of more than five per cent was earned by CCP on its equity with respect to all sales. (139a - 141a) The Government did not impeach the testimony of Peter Cappuccilli nor Paul Kiniry on the question of fair market value and interest nor did the Government offer its own witnesses in rebuttal. Accordingly, it was an error for the Tax Court to disregard the undisputed testimony in the record as to fair market value and interest. It was conceded by petitioner that if interest was imputed, the rate of five per cent was to be used. But since, as aforementioned, more than five per cent was earned by petitioners with respect to all sales, the requirement of section 482 has been met and no other interest should be imputed to CCP. (69a, 107a, 108a, 114a - 120a, 140a, 141a)

Cases hold that accrual basis taxpayers are not required to accrue interest on obligations due them (from non-related parties) if there is no reasonable expectation that interest could be collected. Corn Exchange Bank v. United States, 37 F2d 34 (2d Cir. 1930), Greer-Robbin Co. v. Commissioner, 119 F2d 92, 93 (9th Cir. 1941), Barker v. Magruder, 95 F2d 122 (C. Ct. D.C. 1937), American Cigar Co. v. Commissioner, 66 F2d 425 (2d Cir. 1933). The regulations under section 482 and the Court in the Forman[5] case stated that related taxpayers should deal with each other at arm's length and where interest is not charged the Commissioner is entitled to impute interest. Based on this theory, then the rule should be that if interest could not be collected between non-related parties because of financial inability of the obligor to pay interest, then related parties should be accorded the same standard. In Pitchford's Inc. v. Commissioner, T.C. Memo. 1975-75 the Tax Court held that because the obligor was not economically sound during the year in question, the Commissioner could not allocate interest to the obligee. In that case, the

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[5] B. Forman Company v. Commissioner, 453 F.2d 1144 (C.A.2, 1972), affirming in part and reversing in part 54 T.C. 913 (1970), certiorari denied 407 U.S. 934 (1972).

petitioner used the accrual method of accounting and the Commissioner conceded that interest could not be allocated to petitioner under section 482 if the related obligor's financial situation was so shaky that collection thereof was not reasonably expected. This same rule should apply, nevertheless, to related taxpayers on a cash basis; otherwise the law would be discriminatory. In the instant case the undisputed facts show that the obligor's financial situation was such that there were no funds to pay CCP's interest. Therefore, section 482 should not apply. It is submitted that the rule of law should be as follows:

> Where interest is not paid on obligations due a related party (whether the obligee is on the accrual or cash basis), then section 482 should apply but, only if there is a reasonable expectation that interest could be collected.

ARGUMENT

POINT I

REAL PROPERTY HELD FOR INVESTMENT WHICH IS SOLD ON A TIME BASIS WITHOUT INTEREST DOES NOT COME WITHIN THE PURVIEW OF SECTION 482

The regulations under section 482 provide in part that interest shall be included on all forms of bona fide indebtedness including "indebtedness arising out of the ordinary course of business out of sales . . . by or between members of the group . . ." (Reg. Sec. 1.482-2(a)(3)(ii)). Section 482 does not apply to a sale of a capital asset, which is defined under section 1221 as including all property owned by taxpayer except property used in his trade or business or "property held by taxpayer primarily for sale to customers in the ordinary course of his trade or business." Malat v. Riddell 383 U.S. 569 (1966) interpreted the word "primarily" in section 1221 as referring to property which is held for sale to customers only if that is the "principal purpose or the one of first importance."

However, in the instant case, farm sales made by CCP to its related corporations involved realty which was

held for investment and speculation, and not for sale in the ordinary course of business. (114a, 118a). CCP acquired the five farms making up the Seneca Knolls property as a result of options which it exercised on different dates. The various options were transacted between February 1958 through September 1960. Most of the purchases were concluded in 1961 except for the Higgins farm which closed on January 3rd, 1962. These five farms, which made up the Seneca Knolls tract, were contiguous, and it was the intent of CCP to arrange this package to enhance the value of all farms. Stonehedge, for development purposes, acquired Seneca Knolls on January 10, 1962. (J. Ex. 39 AM) A period of almost four years lapsed from the first option date (Walter farm February 1958) to the time of the sale to Stonehedge on January 10, 1962. In December 1959, CCP took an option on the Henderson Farm, exercised that option in May 1960 and sold said farm to Stonehedge in February 1961 (J. Ex. 39-AM)

CCP, prior to the sale of the Seneca Knolls Tract and the Henderson farm to Stonehedge, did nothing more to these properties other than to negotiate for their purchase. CCP did not develop the tract, did not cut roads, did not install sewage system, did not offer lots for sale, did not

advertise for sale, did not list property with brokers, did not file a subdivision map, did not obtain zoning, did no water testing (perc test), prepared no subdivision or platting. (114a, 118a) In short, there is nothing in the record to indicate that CCP made any improvements whatsoever to these properties (six farms), or offered the properties for sale in the ordinary course of its trade or business. Austin v. Commissioner, 263 F2d 460 (9th Cir. 1959); cf Ralph E. Gordy 36 T.C. 855 (1961), Acq. 1964-1 CB (Pt 1) 4.

On the contrary, the objective of CCP was to acquire these farms for speculative and investment purposes. (114a, 118a). At a later date Stonehedge purchased Seneca Knolls and Henderson farm from CCP. Stonehedge was to develop these properties into approximately 1100 to 1200 building lots to build and sell homes, then use the proceeds to pay off mortgages due to CCP. (102a, 103a, 115a, 116a)

The Preston farm was purchased by CCP on April 15, 1961 and on the next day part of that farm was purchased by Seneca for purposes of building a sewage disposal plant to serve the entire area that was being assembled (Seneca Knolls and Henderson). Nothing was done by CCP to improve the Preston farm. (117a, 118a)

In Gault v. Commissioner, 332 F2d 94 (2d Cir. 1964) this Court, set forth various criteria to be used in determining whether real property is held for sale in the ordinary course of a taxpayer's trade or business, (at page 96):

> "(1) the frequency, number and continuity of sales; (2) subdivision, platting, and other improvements or developments tending to make the property more marketable; (3) the extent to which the taxpayer engaged in sales activity, (4) the length of time the property has been held; (5) the substantiality of the income derived from the sales, and what percentage that is of the taxpayer's total income; (6) the nature of the taxpayer's business; (7) the taxpayer's purpose in acquiring and holding the property; (8) the extent of sales promotional activities such as advertising; (9) the listing of property directly or through brokers."

Accord, Estate of Segal v. Commissioner, 370 F2d 107 (2d Cir. 1966). In the latter case the Court held that the taxpayer was not entitled to capital gain treatment, citing Gault, supra, and also, adding the fact that taxpayer had engaged in short term financing and had mortgage release clauses included in his purchase agreements; which also tended to show a quick turnover of the real estate purchased was contemplated by the taxpayer.

A comparison of the factors cited by this Court in Gault and Segal, supra, with the facts of the instant case, would support the contention that CCP held the subject properties not for sale to customers in the ordinary course of its trade or business but for investments and speculation.

Also in CC favor is the fact that the farms were not shown as inventory although some were owned at the end of 1961. (J. Ex. 10-J, 10-K) Inventory is property held for sale to customers in the ordinary course of taxpayer's trade or business. cf. William S. Grimaldi 22 CCH Tax Ct. Memo 739 (1963); Hugh F. Little 13 CCH Tax Ct. Memo 115 (1954). Although a taxpayer may be a real estate dealer for some properties, he may hold other real estate for investment purpose, it all depends on the type of property and the taxpayer's activity relative to such property prior to sale. Mathews v. Commissioner 315 F2d 101 (6th Cir. 1963), petition for rehearing denied, 317 F2d 360 (6th Cir. 1963). During 1961 and 1962 when the subject properties were sold, they were the only farm sales involved; the only other real estate sold was a bowling establishment. (J. Ex. 10-J, 10-K). See, Mathews v. Commissioner, supra; Goldberg V. Commissioner 223 F2d 709 (5th Cir. 1955).

The profit realized by CCP on its sales of Seneca Knolls and Henderson farm to Stonehedge was derived, not as a result of improvement by CCP, but because of the length of time which elapsed from the option date (earliest was February 1958) to the date of sale, (almost four years for Seneca Knolls) and especially because of the contiguous arrangement of these farms. (99a, 116a) As the Supreme Court stated in Malat v. Riddell, supra, at page 572: "The purpose of the statutory provision with which we deal is to differentiate between 'profits and losses arising from every day operation of a business' on the one hand . . . and the 'realization of appreciation in value accrued over a substantial period of time' on the other . . . ." Cited cases omitted.

The fact that Stonehedge was to do the developing does not affect CCP because a controlled corporation's activities should not be attributed to the controlling party. See Ralph E. Gordy, supra. Of course, property acquired for investment and speculation must be sold ultimately to realize the profit one anticipates when acquiring property, but that fact alone does not signify that the property was acquired for sale to customers in the course of a taxpayer's trade or business. See Scott v. U.S. 305 F2d 460 (Ct. Cls. 1962).

It is true that the public accountant who prepared the tax return for the partnership for the years 1961 and 1962 indicated that the farm sales in question were from sales of assets not qualifying for capital gain treatment as shown on Section D, Form 1065, "Net Gain (or loss) from sale or exchange of property other than capital assets" (J. Ex. 10-J, 10-K). It is difficult to comprehend how he could have made such a classification when CCP did nothing to improve the properties and when, even, he did not classify the farms as inventory. Apparently, the only explanation, other than an honest mistake in designation, was that the public accountant was attempting to offset the loss on the sale of the bowling alley against the gain from the sale of the farms. (J. Ex. 11-K)

However, this classification error should not necessarily be binding against the taxpayer. Cf. Baldwin Locomotive Works v. McCoach 221 F. 59 (3d Cir. 1915) where the company showed appraisal value on its records and Commissioner attempted to tax the increase over cost. And in Atkinson 31 T.C. 1241 (1959) where farm land was erroneously classified as subdivision property on taxpayer's books, the court, nevertheless, held that the farm was not property held for sale to customers.

Although, of evidentiary value, book entries are not conclusive regarding tax consequences. Allen v. Commissioner 117 F2d 364 (1 Cir. 1941); Helvering v. Midland Mutual Life Insurance 300 U. S. 216 (1937) rehearing denied. 300 U. S. 688 (1937). Actual facts control, not book entries. Doyle v. Mitchell Bros. Co. 247 U. S. 179 (1918); W. C. Moody Cotton Co. 2 T.C. 347 (1943) aff'd 143 F2d 712 (5th Cir. 1944). And in Douglas v. Edwards 298 F. 229 (2nd Cir. 1924) reversed, 269 U. S. 204 (1925) on other grounds, the Second Circuit Court of Appeals said at page 234: ". . . the rights of the parties can neither be established nor impaired by the bookkeeping methods employed or by the names given to various items." If the law were otherwise the Government would be bound by any classification a taxpayer desired; but this is not the law. See: Thomas W. Ryan, T. C. Memo 1959-131, Victor H. Lawn, T. C. Memo 1961-78, James E. Blatchford, T. C. Memo 1963-83 aff'd per curiam 337 F2d 1010 (34d Cir. 1964)

The misclassification by the accountant is the only evidence relied on by the Commissioner to hold that the farms were not capital assets. What was said by the Ninth Circuit Court of Appeals is applicable here: "The record does not show a single activity on the part of peti-

tioners that they were holding their property for sale. All that the record shows is that the property was being held by petitioners." Austin v. Commissioner, supra, at page 464.

Nevertheless, in the instant case, the Tax Court gave no consideration to these facts and its opinion does not even discuss the question of whether the farms were capital or non-capital assets. A classification of the farms as capital assets would take the case outside the scope of section 482.

It was an error for the Court to disregard the uncontested evidence supporting taxpayer's contention that the farms were capital assets. Cf. Loesch and Green Construction Co. v. Commissioner 211 F2d 210 (6th Cir. 1954); Tank v. Commissioner 270 F2d 477 (6th Cir. 1959); Alvary v. U. S.302 F2d 790 (2d Cir. 1962).

Concerning the efficacy of the testimony of a party to the action the Supreme Court said: "Where, however, the evidence of a party to the action is not contradicted by direct evidence, nor by any legitimate inferences from the evidence, and it is not opposed to the probabilities; nor in its nature, surprising or suspicious, there is no reason for denying it to conclusiveness." Chesapeake and O. Ry. Co. v. Martin 283 U. S. 209, 218 (1931); but cf. Wood v. Commissioner 338 F2d 602 (9th Cir. 1964). See also:

Georgia Pacific Corp. v. U. S. 264 F2d 161 (5th Cir. 1959) subsequent proceedings 4 AFTR2d 5316 (D.C. S.D. Ga. 1959); Muller v. Commissioner 203 F2d 350 (6th Cir. 1953); Estate of Charles P. Skouras T. C. Memo 1962-33.

Since in this case the facts overwhelmingly support the proposition that the farms, Seneca Knolls, Henderson and Preston, were capital assets, it was error for the Court to hold that section 482 should govern. The Forman case, supra, decided by this Court concerned non-interest bearing loans between related taxpayers, thus it is distinguishable from the facts in this case as concerns the amount due CCP by Stonehedge and Seneca on the farm sales.

POINT II

SECTION 482 DOES NOT APPLY TO REAL ESTATE SALES ON A TIME BASIS WHERE INTEREST WAS INCLUDED AS PART OF THE SELLING PRICE

The details regarding the purchase and sale of the seven farms involved are set forth as follows:

Property	Date Purchased	Date Sold	Cost	Selling Price	Fair Market Value
Preston*	4/15/61	4/16/61	$ 22,500	$ 40,000	$ 21,250
Henderson	3/ 8/60	2/20/61	$125,460	$ 216,500	$175,000
Patterson	11/24/61)				
Commane	10/20/61)				
Walter	2/22/61)	**Seneca Knolls			
Green	10/26/61)	1/10/62		$1,353,600	$720,000
Higgins	1/ 3/62)				

(J. Ex. 39M, 40-AN - 42-AP; 117a - 120a)

Concerning the Preston farm, it is obvious that the selling price of $40,000 was not equal to fair market value at time of sale. The total (40 acres) property was purchased by CCP on April 15, 1961 for $22,500 and one half (or 20 acres) was sold the next day to Seneca for $40,000. The terms of sale were: cash $5,000; mortgage assumed $10,000 and purchase money mortgage and note of $25,000 at six per cent interest to be paid in full on April 16, 1966. (117a - 120a) Peter Cappuccilli (an equal partner and owner of the entities involved) had extensive experience in the real estate business (25 years) was familiar with real estate values in Onondaga County where all of the subject property is located. He also was familiar with interest rates, because he transacted the financing for the entities involved. (92a - 96a) Peter Cappuccilli testified that the

*Only one half was sold to Seneca; the cost of one half would be $11,250, which sold for $40,000.

**Seneca Knolls property - five farms.

fair market value of one-half of Preston farm sold to Seneca was $21,250 on the date of sale (119a). CCP's equity in Preston farm was $6,250 (119a). Peter Cappuccilli further testified that the difference between the selling price of $40,000 and the fair market value of $21,250 or $18,750 represented an interest element of at least seven per cent. Although full payment was due in 1966, the $25,000 note was not paid until 1973, 12 years from date of sale. (119a, 120a) No contradictory evidence was offered by the Government as to the fair market value at time of sale or CCP's equity; nor did the Government contest Mr. Cappuccilli's creditability as an expert in real estate nor his familiarity with interest rates.

Paul Kiniry testified that based on interest tables, if $6,250 (equity in Preston farm) were invested for 12 years during which time no payment of principal or interest was made, and at the end of the 12 years, a lump sum of $25,000 was paid, then interest of about twelve per cent would have been earned on the $6,250. (141a) Petitioner and respondent stipulated that if interest is to be imputed by the Court, a five per cent rate would be used (18a, 34a, 50a, 69a). Paul Kiniry gave uncontradicted testimony that interest of more than five per cent was earned by CCP on the Preston farm sale. Therefore, the application of section 482 by the Tax Court on the Preston transaction was erroneous.

The Henderson farm was sold on February 20, 1961 by CCP to Stonehedge for $216,500; the terms of sale were: cash $27,894.86, mortgage assumed $107,605.14 and purchase money mortgage and note of $81,000 at six per cent interest, to be paid $40,500 on February 20, 1962 and $40,500 on February 20, 1963. (J. Ex. 33-AG - 39-AM)

Peter Cappuccilli testified that the fair market value of Henderson farm at the time of sale was $175,000 and that the difference in selling price was interest of $41,500 or about 7-8 per cent on CCP's equity (115a-117a). CCP's equity in Henderson farm was approximately $29,000 after applying payment of $11,000 (made in 1962), leaving a balance of $70,000. This amount was satisfied as a result of a foreclosure in March 14, 1972 or about 11 years from date of sale. (107a, 108a, 117a; Ex. 45)

Paul Kiniry testified that on an equity of $29,000 in which no interest or principal was paid for a 12-year period and where a total of $70,000 was paid at the end of the 12-year period, an interest factor of at least 7% would have been earned on the $29,000. (114a, 115a)

The government offered no contradictory testimony regarding the fair market value of Henderson farm at time of sale, CCP's equity, or the interest earned on the equity. Therefore it was error for the Tax Court to apply section 482 to the Henderson sale.

Seneca Knolls property was sold by CCP to Stonehedge on January 10, 1962 for $1,353,600; payment terms were: cash $3,430, mortgage assumed $275,170 and purchase money mortgage and note to CCP of $1,075,000. $75,000 was to be paid on January 10, 1964 and $100,000 on each succeeding anniversary date until paid. According to Peter Cappuccilli the fair market value at time of sale was $720,000 and CCP's equity at time of sale was about $400,000. (J. Ex. 36-AJ, 39-AM, 101a) Peter Cappuccilli testified that the difference between selling price and fair market value was interest of $633,600 at a factor of 7-8 per cent (101a, 102a). Of the $1,075,000 note, a balance of $1,052,850 was outstanding as of March 14, 1972. This amount was satisfied as a result of a foreclosure by CCP against Stonehedge on March 14, 1972 or about 10 years from date of sale. (107a, 108a, 117a, Ex. 45)

Paul Kiniry testified that on an equity of $400,000 which is paid in lump sum of $1,075,000 at the end of a 12-year period (January 10, 1962 to January 10, 1974) an interest factor of at least 8½ per cent would have been earned on the $400,000 equity.[6] Mr. Kiniry testified that

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[6]The equity based on fair market value of $720,000 should have been $441,400 computed by deducting cash of $3,430 and mortgages assumed of $275,170; according to the interest tables, Ex. 50, under the same time and payment period an equity of $441,400 would have earned interest of 7.71 per cent.

if a note obligation is paid in full prior to maturity date, then a greater interest rate would be earned (140a). Payment on Seneca Krolls mortgage note was satisfied in about 10 years and Mr. Kiniry used tables for 12 years.

The government offered no testimony to contradict the fair market value of Seneca Knolls or CCP's equity at time of sale or the interest rate as computed by Mr. Kiniry. Accordingly, the Tax Court was in error in the application of section 482 to the Seneca Knolls mortgage, because at least five per cent was earned thereon.

It should be emphasized that as to the three sales involved, respondent did not impeach petitioner's witnesses, nor did he offer rebutting evidence as to fair market value, equity or interest as testified to by witnesses for petitioners.

The expert testimony of a witness after a proper foundation has been laid, as to his qualifications, constitutes admissable evidence and the Court should not disregard the uncontradicted and inherently credible testimony of a qualified expert. Tank v. Commissioner, 270 F2d 477 (6th Cir. 1959); Cullers v. Commissioner, 237 F2d 611 (8th Cir. 1956). The Tax Court should not disregard credible expert testimony where the opposing party offered no rebutting testimony. Belridge Oil Co. v. Commissioner, 85 F2d 762 (9th Cir. 1936); Alvary v. U. S., 312 F2d 790 (2nd Cir. 1962).

Also a trial court should not disregard what appears to be substantial and reliable testimony without giving any reasons therefor. Loesch & Green Construction Co. v. Commissioner, 211 F2d 210 (6th Cir. 1954).

Where evidence is credible, reasonable, uncontradicted and unimpeached, the tax court may not disregard it. Georgia Pacific Corp. v. U. S., 264 F2d 161 (5th Cir. 1959) subsequent proceedings 4 AFTR2d 5316 (D.C. S.D. GA 1959); Estate of Charles P. Skouras T. C. Memo 1962-33.

Evidence of an interested witness should not be disregarded merely because of the identity of the witness. Chesapeake & Ohio Railroad Co. v. Martin, 283 U. S. 209, 218 (1931); Muller v. Commissioner, 203 F2d 350 (6th Cir. 1953); but, cf. Wood v. Commissioner, 338 F2d 602 (9th Cir. 1964)

The Tax Court stated that it did not believe that petitioners intended to include interest in the selling price of the real estate sold by CCP. Quoting the Court:

> "This contention is properly to be sustained only upon a demonstration that in each instance the realty was intentionally sold at a price exceeding its fair market value by the amount of interest that would have accrued at a definite rate over the term of the contract of sale. Elliot Paint & Varnish Co., 44 BTA 241 (1941); Kingsford Co.; 41 T.C. 646 (1964)."
> (82a, 83a)

In Elliot Paint & Varnish Co., supra, property was sold for $40,000 to be paid in periodic installments over 15 years.

The Court held that no part of the payment was interest. However, there was no opinion evidence of the value of the property at the time it was sold. In the instant case, Peter Cappuccilli, a qualified real estate expert, testified without contradiction as to the fair market value at the time of sale with respect to all subject properties sold by CCP.

The Court, in Kingsford, supra, held that although the seller would have taken a cash price of $1,300,000 as against the installment price of $1,522,000 the difference did not represent interest, because sometimes a seller would sell at a discount to get an immediate cash payment. Other cases have held that unless the agreement is clear that interest was intended, the courts will not find interest as being included in the selling price. Anderson & Co. 6 BTA 713, 717 (1937) Clay B. Brown 325 F2d 313 (9th Cir. 1962) aff'g. 37 T.C. 461, 488 (1961).

Where the Courts have found that interest was included in the purchase price it was because the seller and purchaser in their agreement contemplated a payment in the nature of interest. Judson Mills 11 T. C. 25, 33 (1948) acq. 1949-1 C.B. 2; Hudson-Duncan & Co. 36 BTA 554, 557 (1937), acq. 1938-1 C.B. 5 (discount allowed if paid before maturity); Estate of Betty Berry 43 T.C. 723 (1965) aff'd per curiam 327 F2d 476 (6th Cir. 1967) cert. den. 389 U.S.

834 (1967) (discount allowed if paid before maturity).

Interest has been defined as compensation for the use or forbearance of money. Lloyd v. C.I.R. 154 F2d 643, 646 (3rd Cir. 1946). Thus, where a seller forgoes immediate cash payment and takes a larger sum over a period of time, he is in effect being compensated by the purchaser. Therefore, it is respectively submitted that the cases which hold that interest is not necessarily included when an installment sales price is greater than a cash price, do not conform with the realities of the financial world. No one who appreciates the value of money would pay a cash price for an article if he could pay the same price in installments over a period of years. And, section 483 added by the 1964 Revenue Act (passed February 20, 1964) buttresses this opinion.

Prior to the enactment of Section 483 if a capital asset was sold on the installment basis without separately stating interest, the full difference between the cost basis of the capital asset and its selling price was considered capital gain to the seller. In effect the seller converted ordinary income (the interest which would have been stated separately) into capital gain by this method. See United States v. Cornish, 348 F2d 175, 183, 184 (9th Cir. 1965).

But Congress realized that "there is no reason for not reporting amounts as interest income merely because

the seller and purchaser did not specifically provide for interest payments. This treats taxpayers differently in what are essentially the same circumstances merely on the grounds of the names assigned to the payments." Sen. Rep. No. 830, 88th Cong. 2d Sess. p 102. Consequently, section 483 was passed, and it provides in essence that a part of each installment payment shall be considered interest in those installment contracts which provide for no interest or for interest which is less than that provided for under the regulations.

It would appear that by the enactment of section 483, Congress has effectively overruled the cases which held that interest is not necessarily included in a deferred payment sales where the selling price would exceed a cash sale.[7]

The Tax Court also indicated that interest was not intended by CCP because there was no provision in the agreements providing for a discount if payments were made before maturity. However, the instant case differs from those cited by the Court because of the relationship of the parties involved. Peter Cappuccilli was a partner in CCP and an equal stockholder in Stonehedge and Seneca. He handled the transactions for all entities involved. Therefore, the extrinsic evidence, such as memoranda, letters,

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[7] It should be noted that the cases cited were either decided or tried prior to the passage of the 1964 Revenue Act.

supplemental agreements, etc. as was shown in Judson Mills, Hudson-Duncan Co. and Estate of Betty Berry, supra, (cited by the Court) that would normally be present between non-related parties, was of course, lacking in the instant case. Also, a discount on prepayment is a matter which could be negotiated at the time a purchaser intends to make such repayment, and he would be unwise to prepay the full amount due on an installment contract if no discount was offered by the seller.

The Tax Court further pointed out that there were different interest rates (7.5, 8.5 and 12 per cent) involved on the sales for which no explanation was given. Nevertheless, there was no evidence submitted by respondent rebutting the fact that in each of the three sales the selling price substantially exceeded the fair market value at time of sale. It would seem that, although the interest rates varied for the three sales involved, as long as interest of five per cent or more was included in the selling price, the requirements of section 482 have been met.

Accordingly, it is respectively submitted that the cases cited by the Tax Court, Elliot and Kingsford, supra, are inapposite, because of section 483, and that the Court erred in holding that additional interest of five per cent should be imputed to CCP under section 482.

POINT III

IF AN OBLIGOR HAS NO FUNDS WITH WHICH TO PAY INTEREST ON OBLIGATIONS IT OWES TO A TAXPAYER WHO CONTROLS THE OBLIGOR, THEN SECTION 482 SHOULD NOT APPLY

The facts in the instant case show that the related entitied, Stonehedge, Seneca and Cappy, which were obligated to CCP had insufficient funds with which to pay CCP the interest which the respondent is imputing to CCP for the years 1967, 1968 and 1969.

From the income tax returns admitted into evidence the pertinent financial facts of Stonehedge, Seneca and Cappy follow:

	Taxable Income	Cash Balance	Current Liabilities
Stonehedge			
December 31, 1967	$ 2,835.09	$1,948.79	$ 115,879.12
December 31, 1968	*(57,780.03)	3,099.85	1,409,507.10
December 31, 1969	(113,177.10)	1,640.44	1,414,056.67
(Jt. Ex. 25-Y, 26-Z, 27-AA)			
Seneca			
June 30, 1968	-0-	$ 400.41	$ 124,443.73
June 30, 1969	-0-	300.04	149,428.29
(Jt. Ex. 30-AD, 31-AE)			
Cappy			
December 31, 1967	-0-	$13,271.84	$ 127,078.94
(Jt. Ex. 32-AF)			

As can be readily noted, Stonehedge had taxable income, $2,835.09, for 1967 and very substantial losses for

*Brackets indicate losses.

1968 ($57,780.03), and for 1969, ($113,177.10). Its current liabilities at the end of the three years far exceeded the small cash balance on hand. The same situation prevailed for Seneca (1968-1969) and Cappy (1967).

Further, Peter Cappuccilli testified that CCP made advances to Stonehedge, Seneca and Cappy to keep the companies in operation and to allow them to pay other mortgages because these companies could not borrow from banks. (122a, 123a)

Stonehedge, Seneca and Cappy encountered many financial set backs because of the zoning problems, New York State appropriation, the depressed real estate market and the tight money situation during the early 1960's. (104a-106a) As a result of the aforementioned setbacks, development by Stonehedge was impaired and this also affected Seneca and Cappy, because they were engaged in related real estate activities which depended on Stonehedge's ability to develop homes. Consequently, these companies did not have the funds necessary to repay CCP during the tax years involved. (106a, 122a, 123a)

This Court in the Forman case, supra, held, inter alia, that related parties must deal with each other at arm's length and that the Commissioner has broad power under section 482 to allocate income or deductions (where related parties are concerned) in order to prevent evasion of taxes and to clearly reflect income of such related parties.

However, the Courts have recognized that in non-related taxpayer situations, if collection of interest is not reasonably expected, the obligee is not required to report interest income. Corn Exchange Bank v. United States, 37 F2d 34 (2d Cir. 1930), Greer-Robbin Co. v. Commissioner 119 F2d 92, 93 (9th Cir. 1941), Barker v. Magruder 95 F2d 122 (C. Ct. D.D. 1937), American Cigar Co. v. Commissioner 66 F2d 425 (2d Cir. 1933)

In Corn Exchange Bank, supra, (involving an accrual basis taxpayer), the Court said at page 34:

> "When a tax is lawfully imposed on income not actually received, it is upon the basis of a reasonably expectancy of its receipt, but a taxpayer should not be required to pay a tax when it is reasonably certain that such alleged accrued income will not be received and when in point of fact it never was received."

The example given by Judge Augustus N. Hand in his concurring opinion at page 35 is relevant:

> "If A loaned $100,000 to B and the latter was a hopeless insolvent, but A did not know it, can it be thought that A would create taxable income by mistakenly entering interest upon the loan upon his books? What the government is permitted by the Constitution to tax is real not supposed income."

In Borge v. Commissioner 405 F2d 673 (2d Cir. 1968) cert. denied, sub nom Danica Enterprise, Inc. v. Commissioner 395 U. S. 933 (1969) the Court found that an individual stockholder and his wholly owned corporation satisfied the two or more businesses required of section 482. In that

case the Commissioner allocated income to Victor Borge from his wholly owned corporation because the agreement between them was not at arm's length, and this Court upheld that determination. But suppose, for example, in Borge, the corporation had no income, would Victor Borge have been assessed the same compensation? It hardly seems likely. Likewise, if Borge loaned $100,000 to his company and there were no funds to pay his interest, could the Court hold that interest income should be allocated, to Victor Borge, regardless?

In Commissioner v. First Security Bank of Utah, 405 U.S. 394 (1972) the Commissioner attempted to charge various banks with commissions on insurance policies which the banks were responsible for initiating but, because it was against the banking law for banks to engage in insurance business, or to act as insurance agents, the banks referred the policies to an independent company without charging a commission. The independent company and the banks were part of a related group of companies. The Commissioner was unsuccessful in attempting to allocate part of the commission income to the banks.

While First Security Bank of Utah concerned the allocation of prohibitive income, parts of the decision are relevant to our case. Justice Powell in stating that the question was "whether there was a shifting or distorting

of the Banks' true net income . . ." (pp 400-401) said at page 403:

> "We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving. In cases dealing with the concept of income it has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income a taxpayer must have complete cominion over it." (Emphasis added)

Based on the financial situation of Stonehedge, Seneca and Cappy during the years in question CCP could not have received interest because there were no funds available to pay CCP. Even non-related parties would not have been paid interest on obligations due them had it not been for advances CCP made to Stonehedge and Seneca. See also L. E. Shunk Latex Products, Inc. v. Commissioner 18 T.C. 940, 961 (1952) cited by the Supreme Court in First Security Bank of Utah, supra, where the Tax Court held that the Commissioner "had no authority to attribute to petitioners income which they could not have received."

Although, the cases holding, that an accrual basis taxpayer is not required to accrue interest income where collection is not reasonably expected, (Corn Exchange, Greer-Robbin, Barker, American Cigar, supra) were decided prior to the promulgation of regulations under section 482, the Commissioner has accepted this rule more recently in

Pitchford's Inc. v. Commissioner T.C. Memo 1975-75 which involved related taxpayers. The Tax Court held that where the obligor was not economically sound during the tax years involved, the Commissioner could not allocate interest income to the controlling obligee (taxpayer). The peitioner used the accrual method of accounting and the Commissioner conceded that he could not allocate interest income to petitioner under section 482 if the obligor's financial condition was so shaky that there was no reasonable expectancy of collection. Therefore, if as between related taxpayers no interest should be imputed to an accrual basis taxpayer (obligee) because of the obligor's shaky financial situations, the same rule should apply (to related taxpayers) if the obligee happens to be on the cash basis. If funds are not available to pay an accrual basis taxpayer, they certainly would not be available to pay a cash basis taxpayer. Any other rule would be discriminatory against cash basis taxpayers who make loans to related parties.

It should be noted that the respondent did not contradict the testimony of petitioner as to the financial inability of Stonehedge, Seneca and Cappy to pay interest to CCP for the years in question. In the Forman case, supra, there was no evidence whether funds were available to pay interest. But regardless, it is respectfully submitted that based on the cases previously cited (Pitchford's, L. E. Shunk Latex Products, Inc., First Security Bank of Utah,

Corn Exchange Bank, supra) the rule to be applied in section 482 cases involving interest on obligations between related parties should be:

> Where interest is not paid on obligations due a related party, (whether the obligee is on a cash or accrual basis), then section 482 should apply, but only if there is a reasonable expectation that interest could be collected.

According to the facts in the instant case, Stonehedge, Seneca and Cappy were not financially sound during 1967, 1968 and 1969, (the tax years in issue), to make interest payments to CCP on the mortgages and advances owed to CCP. Therefore, the Tax Court erred in imputing interest to CCP under Section 482.

CONCLUSION

The Tax Court decision should be reversed and judgment entered in favor of petitioners-appellant.

Respectfully submitted,

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APPENDIX

APPENDIX

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

Section 482
Section 483
Section 1221

Treasury Regulations Under the 1954 Code:

Section 1.482-1
Section 1.482-2

SPECIFIC PORTIONS OF STATUTES AND REGULATIONS RELIED UPON

STATUTES

1954 Code

Sec. 482

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

REGULATIONS

1954 Code

Sec. 1.482-1

(a)(3) The term 'controlled' includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. . . .

. . .

(6) The term 'true taxable income' means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length.

(b) Scope and purpose. (1) the purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

. . .

(d) Method of allocation. (1) The method of allocating, apportioning, or distributing income, deductions, credits, and allowances to be used by the district director in any case, including the form of the adjustments and the character and source of amounts allocated, shall be determined with reference to the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income. The appropriate adjustments may take the form of an increase or decrease in gross income, increase or decrease in deductions (including depreciation), increase or decrease in basis of assets (including inventory), or any other adjustment which may be appropriate under the circumstance . . . .

(2) Whenever the district director makes adjustments to the income of one member of a group of controlled

taxpayers (such adjustments being referred to in this paragraph as 'primary' adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustment shall actually be made if the U. S. income tax liability of the other member would be affected for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the U.S. income tax liability of the other member for any pending taxable year. . . . If a correlative adjustment is not actually made because it would have no effect on the U. S. income tax liability of the other member involved in the allocation for any pending taxable year, such adjustment shall nevertheless be deemed to have been made for the purpose of determining the U. S. income tax liability of such member for a later taxable year, or for the purposes of determining the U. S. income tax liability of any person for any taxable year . . . .

. . .

(4) If the members of a group of controlled taxpayers engage in transactions with one another, the district director may distribute, apportion, or allocate income, deductions, credits, or allowances to reflect the true taxable income of the individual members under the standards set forth in this section and in §1.482-2 notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period . . . . if one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year. The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members.

Sec. 1.482-2

Determination of taxable income in specific situations. - (a) Loans or advances - (1) In general. Where one member of a group of controlled entities makes a loan

or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate as defined in subparagraph (2) of this paragraph, the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.

(2) Arm's length interest rate. For the purposes of this paragraph, the arm's length interest rate shall be the rate of interest which was charged, or would have been charged at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. . . . If the creditor was not regularly engaged in the business of making loans or advances of the same general type as the loan or advance in question to unrelated parties, the arm's length rate for purposes of this paragraph shall be. . .

(i) The rate of interest actually charged if at least 4 but not in excess of 6 percent per annum simple interest,

(ii) 5 percent per annum simple interest if no interest was charged or if the rate of interest charged was less than 4, or in excess of 6 percent per annum simple interest, . . .

(3) Loans or advances to which subparagraph (1) applies. Subparagraph (1) of this paragraph applies to all forms of bona fide indebtedness and includes:

~~(i) Loans or advances of money or other~~ consideration (whether or not evidenced by a written instrument), and

(ii) Indebtedness arising in the ordinary course of business out of sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.

Sec. 483 (1954 Code)

(a) AMOUNT CONSTITUTING INTEREST--For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

(b) TOTAL UNSTATED INTEREST--For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of--

(1) The sum of the payments to which this section applies which are due under the contract, over

(2) The sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of a payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary or his delegate. Such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment.

(c) PAYMENTS TO WHICH SECTION APPLIES--

(1) IN GENERAL--Except as provided in subsection (f), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract---

(A) under which some or all of the payments are due more than one year after the date of such sale or exchange, and

(B) under which, using a rate provided by regulations prescribed by the Secretary or his delegate for purposes of this subparagraph, there is total unstated interest.

Any rate prescribed for determining whether there is total unstated interest for purposes of subparagraph (B) shall be at least one percentage point lower than the rate prescribed for purposes of subsection (b)(2).

(2) TREATMENT OF EVIDENCE OF INDEBTEDNESS--For purposes of this section, an evidence of indebtedness of the purchaser given in consideration for the sale or exchange of property shall not be considered a payment, and any payment due under such evidence of indebtedness shall be treated as due under the contract for the sale or exchange.

(d) PAYMENTS THAT ARE INDEFINITE AS TO TIME, LIABILITY, OR AMOUNT---In the case of a contract for the sale or exchange of property under which the liability for, or the amount or due date of, any portion of a payment cannot be determined at the time of the sale or exchange, this section shall be separately applied to such portion as if it (and any amount of interest attributable to such portion) were the only payments due under the contract; and such determinations of liability, amount, and due date shall be made at the time payment of such portion is made.

(e) CHANGE IN TERMS OF CONTRACT---If the liability for, or the amount or due date of, any payment (including interest) under a contract for the sale or exchange of property is changed, the "total unstated interest" under the contract shall be recomputed and allocated (with adjustment for prior interest (including unstated interest) payments) under regulations prescribed by the Secretary or his delegate.

(f) EXCEPTIONS AND LIMITATIONS---

(1) Sales price of $3,000 or less---This section shall not apply to any payment on account of the sale or exchange of property if it can be determined at the time of such sale or exchange that the sales price cannot exceed $3,000.

(2) Carrying charges---In the case of the purchaser, the tax treatment of amounts paid on account of the sale or exchange of property shall be made without regard to this section if any such amounts are treated under section 163(b) as if they included interest.

(3) Treatment of seller---In the case of the seller, the tax treatment of any amounts received on account of the sale or exchange of property shall be made without regard to this section if no part of any gain on such sale or exchange would be considered as gain from the sale or exchange of a capital asset or property described in section 1231.

(4) Sales or exchanges of patents---This section shall not apply to any payments made pursuant to a transfer described in section 1235(a)(relating to sale or exchange of patents).

(5) Annuities---This section shall not apply to any amount the liability for which depends in whole or in part on the life expectancy of one or more individuals and which constitutes an amount received as an annuity to which section 72 applies.

Sec. 1221 (1954 Code)

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include---

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by---

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

Records and Briefs for State and Federal Courts

SPAULDING LAW PRINTING CO. ESTABLISHED 1881

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RUSSELL D. HAY, owner

AFFIDAVIT OF SERVICE

RE: PADUANO and CAPPUCCILLI v. COMMISSIONER OF INTERNAL REVENUE

STATE OF NEW YORK)
COUNTY OF ONONDAGA) ss.:
CITY OF SYRACUSE)

EVERETT J. REA , being duly sworn, deposes and says:

That he is associated with Spaulding Law Printing Company of Syracuse, New York, and is over twenty-one years of age.

That at the request of VICTOR CHINI, Attorney for Petitioners-Appellants,
(s)he personally served ~~three (3)~~ two (2) copies of the printed ~~[Record]~~ [Brief] and one (1) copy o
[Appendix] of the above-entitled case addressed to:

SCOTT P. CRAMPTON, ESQ.
Assistant Attorney General
Tax Division
U.S. Dept. of Justice
Washington, D.C. 20530

by depositing true copies of the same securely wrapped in a postpaid wrapper in a Post Office maintained by the United States Government in the City of Syracuse, New York on Sept. 5, 1975.

Everett J. Rea

Everett J. Rea

Sworn to before me this 5th
day of Sept. , 1975.

Ruth L. Mahoughney
Commissioner of Deeds

cc: Victor Chini, Esq.

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